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SUBJECT: CENTRAL BANK TIGHTENS - AGAIN

1. SUMMARY: THE NATIONAL BANK OF SERBIA REACTED TO APRIL'S HIGHER INFLATION BY FURTHER TIGHTENING MONETARY POLICY. THE CENTRAL BANK NOT ONLY RAISED THE RESERVE REQUIREMENT ON OVERSEAS BORROWING BY BANKS, BUT IT ALSO FORMALLY IMPOSE LIMITS ON BANKS' RETAIL LENDING, TIED TO THEIR BASIC EQUITY CAPITAL. BANKS COMPLAIN THAT THESE MEASURES WILL DRIVE UP INTEREST RATES AND ENCOURAGE CORPORATE CLIENTS TO EVADE THE RESTRICTIONS ALTOGETHER BY BORROWING OVERSEAS. THE SUBSTANTIAL DETERIORATION IN THE CURRENT ACCOUNT DEFICIT FOR THE FIRST QUARTER ALSO PLAYED A ROLE IN THE CENTRAL BANK'S REACTION, WITH THE BANK POINTING TO A CLOSE CORRELATION BETWEEN CONSUMER CREDIT AND IMPORTS. CENTRAL BANK GOVERNOR JELASIC REPORTS "ZERO" INTEREST FROM THE IMF IN A NEW FUND PROGRAM. END SUMMARY.

INFLATION RISING, WHILE CURRENT ACCOUNT DEFICIT WORSENS

2. APRIL'S HIGH INFLATION HAS FLATTENED HOPES THAT SERBIA COULD ACHIEVE SINGLE-DIGIT INFLATION IN 2006. INFLATION WAS UP 1.8 PERCENT IN APRIL, THUS REACHING 4.1 PERCENT COMPARED TO DECEMBER 2005, AND 15.6 PERCENT IN THE YEAR ENDING APRIL 30. QUARTERLY INFLATION WAS THE RESULT OF HIGHER OIL PRICES (0.8 OF THE 4.1 POINTS), ELECTRICITY (0.8 PERCENT) AGRICULTURAL PRODUCTS (0.5 PERCENT), WHILE CORE INFLATION WAS 2.5 PERCENT. AFTER CONSUMER PRICES ROSE BY 17.7 PERCENT IN 2005, THE FINANCE MINISTER HAD PREDICTED SINGLE DIGIT INFLATION FOR 2006, BUT CENTRAL BANK GOVERNOR RADOVAN JELASIC, IN A MAY 9 MEETING WITH ECON CHIEF, NOTED THAT THE BANK HAD NEVER EMBRACED THAT PREDICTION.

3. AT THE SAME TIME, THE FOREIGN TRADE DEFICIT IN THE FIRST QUARTER OF 2006 WAS UP BY 34.4 PERCENT COMPARED TO SAME PERIOD LAST YEAR. HOWEVER, THESE NUMBERS GENERALLY ARE CONSIDERED SUSPECT BECAUSE THE INTRODUCTION OF THE VALUE ADDED TAX LAST YEAR SHIFTED IMPORTS INTO DECEMBER 2004 INSTEAD OF Q1 2005. EXPORTS WERE UP BY A HEALTHY 27.6 PERCENT FOR THE FIRST QUARTER. JELASIC NOTED THAT HE IS NOT WORRIED BY THE CURRENT ACCOUNT RESULTS.

4. JELASIC SAID THAT HE FOUND "ZERO" INTEREST IN A NEW PROGRAM WHEN HE MET WITH THE IMF WHILE IN WASHINGTON IN LATE APRIL FOR THE ANNUAL MEETINGS. HE SAID THE FUND REGARDED THE LAST PROGRAM AS LESS THAN SUCCESSFUL, GIVEN HIGH INFLATION, AND WAS NOT EAGER TO TRY AGAIN. AND THE FUND WOULD BE LOOKING FOR AN AMBITIOUS PROGRAM WITH REGARD TO STRUCTURAL REFORM, EVEN IF SERBIA PUSHED FOR A PROGRAM. THE FUND ALSO COULD SEEK A REVISED 2006 BUDGET TO COPE WITH INFLATION.

CENTRAL BANK AGAIN SEEKS TO CURB CREDIT GROWTH

5. THE NBS FACED A DIFFICULT TASK AS IT TRIED TO STERILIZE RISING INFLOWS OF FOREIGN CURRENCY OVER THE LAST 12 MONTHS. JELASIC SAID THAT THE BANK TOOK IN ANOTHER 612 MILLION DOLLARS IN THE FIRST QUARTER, WITH THE CENTRAL BANK'S RESERVES NOW UP TO USD 6.4 BILLION, DESPITE A DECLINE IN THE BANK'S INTERVENTION IN THE FOREIGN EXCHANGE MARKET. IN 2005, CAPITAL INFLOWS AMOUNTED TO 3 BILLION EUROS (57 PERCENT OF M3), AND THAT TENDENCY CONTINUED IN THE FIRST QUARTER OF 2006 WITH AN INFLOW OF 804 MILLION EUROS. ONE NEGATIVE DEVELOPMENT IS THE HIGH SHARE OF DEBT IN THE TOTAL CAPITAL INFLOW, FROM 61 PERCENT OF FLOWS IN 2005 TO 78 PERCENT IN THE FIRST QUARTER. THIS REFLECTS COMMERCIAL BANK BORROWING FROM PARENT COMPANIES ABROAD.

6. THE RISE IN INFLOWS WAS MATCHED BY AN ACCELERATION IN CREDIT GROWTH. IN THE PERIOD JANUARY-MARCH, COMMERCIAL BANKS' CREDITS INCREASED BY USD 646 MILLION, I.E. 11.3 PERCENT (CONSUMER LENDING BY 13.1 PERCENT, AND CORPORATE LENDING, 10.5 PERCENT). IN THE SAME PERIOD OF 2005, CREDIT GROWTH WAS 10.6 PERCENT (CONSUMER LENDING 8.4 PERCENT, CORPORATE LENDING 11.3 PERCENT).

7. ALTHOUGH THE CENTRAL BANK HAD JUST INTRODUCED MORE RESTRICTIONS ON MARCH 30, IT REACTED AGAIN ON MAY 8; JELASIC TOLD ECON CHIEF THAT HE WAS FORCED TO ACT BY THE WORSENING INFLATION NUMBERS. THESE MEASURES WERE TAKEN IN ANTICIPATION OF MORE INFLATIONARY PRESSURES IN MAY, JELASIC SAID, INCLUDING A FURTHER OIL PRICE INCREASE OF 4-5 PERCENT, A TELEPHONE PRICE INCREASE OF 10 PERCENT, AND A SEASONAL RISE

OF AGRICULTURAL PRICES. JELASIC SAID THAT HE COULD NOT WAIT FOR MORE DATA, ESPECIALLY AFTER READING IN A RECENT FITCH RATING THAT SERBIA HAS THE SECOND HIGHEST INFLATION AMONG 98 COUNTRIES IT RATES.

18. THE CENTRAL BANK MEASURES INCLUDE:

-- AN INCREASE OF THE RESERVE REQUIREMENT ON FOREIGN BORROWING AND FOREIGN EXCHANGE DEPOSITS OF UP TO TWO YEARS, FROM 40 TO 60 PERCENT; THE CENTRAL BANK CITED THE JUMP IN BANKS' SHORT TERM EXTERNAL BORROWING, WHICH ALMOST TRIPLED OVER LAST 12 MONTHS TO EURO 2.4 BILLION (11 PERCENT OF GDP).
-- HOUSEHOLD LENDING WILL BE LIMITED TO 200 PERCENT OF BANKS' EQUITY CAPITAL, WITH A PHASE-IN BY SEPTEMBER 30. THE CENTRAL BANK CITED THE HIGH GROWTH OF CREDITS TO HOUSEHOLDS, AS WELL AS THE HIGH CORRELATION BETWEEN CONSUMER CREDITS AND THE CURRENT ACCOUNT DEFICIT.
-- BANKS WILL BE OBLIGED TO PROVIDE ADDITIONAL CAPITAL OF 25 PERCENT FOR LOANS THAT EXCEED 10 MILLION DINARS IN FOREIGN CURRENCY, OR LINKED TO A FOREIGN CURRENCY, UNLESS THE BORROWER HAS ADDITIONAL SECURITY AGAINST EXCHANGE RATE RISK, SUCH AS FOREIGN EXCHANGE REVENUES.
-- ON MAY 15, A SECOND ROUND OF NBS SAVINGS BILLS WILL BE ISSUED TO RETAIL CUSTOMERS IN THE AMOUNT OF USD 14.3 MILLION, WITH AN ANNUAL INTEREST RATE OF 24 PERCENT.

19. JELASIC DEFENDED THE MEASURES BY ARGUING THAT BANKS ARE FREE TO CONTINUE CONSUMER LENDING AS LONG AS THEY ARE WILLING TO INCREASE THEIR EQUITY. HE NOTED THAT ONE TARGET OF THE MEASURES WAS THE PRACTICE OF CERTAIN BANKS TO FUND THEIR LENDING VIA SHORT-TERM DEPOSITS FROM PARENT BANKS. THE BANK HOPES TO PROMOTE A GREATER RELIANCE ON DOMESTIC DEPOSITS TO FINANCE LENDING, SINCE THEY REMAIN SUBJECT TO A LOWER RESERVE REQUIREMENT OF 40 PERCENT. WHEN ECON CHIEF ASKED WHEN HOW THE BANK PROPOSED TO EXIT FROM SUCH QUANTITATIVE LIMITS ON RETAIL LENDING, JELASIC SAID THAT THE LIMITS COULD BE ADJUSTED OVER TIME AS CONDITIONS WARRANT.

10. THE TIGHTENING PROVOKED VOCAL OPPOSITION AMONG COMMERCIAL BANKS. JUST TWO DAYS AFTER THE NATIONAL BANK INTRODUCED THE MEASURES, GERMAN-AUSTRIAN HVB BANK ANNOUNCED THAT IT WOULD BE FORCED TO INCREASE RATES ON ALL RETAIL CREDITS, EXCEPT MORTGAGES. ANNUAL INTEREST RATES FOR CONSUMER CREDITS WILL RISE TO 14.77 PERCENT. ALEXANDER PICKER, HVB GENERAL MANAGER, SAID HIS BANK WOULD FEEL THE PINCH IMMEDIATELY, SINCE IT ALREADY IS AT THE 200 PERCENT LIMIT FOR RETAIL LENDING IN RELATION TO EQUITY. OTHER BANKS, WHICH ARE MORE HIGHLY LEVERAGED, WOULD BE HIT HARDER, HE SAID. THE CENTRAL BANK'S APPROACH IS NOT MARKET-BASED, HE COMPLAINED.

11. THE HEAD OF THE MANAGEMENT BOARD OF RAIFFEISEN BANK, BUDIMIR KOSTIC, AGREED THAT THE LATEST MEASURES WILL PUSH BANKS TO RAISE INTEREST RATES BY 2-2.5 PERCENTAGE POINTS. HE ARGUED THAT THE CENTRAL BANK'S POLICY WILL DECREASE COMPETITIVENESS BY INCREASING COSTS TO THE CORPORATE SECTOR. KOSTIC, WHO ALSO IS THE HEAD OF THE SERBIAN ASSOCIATION OF BANKS, WARNED THAT THE CENTRAL BANK'S TOUGH MONETARY POLICY HAD FAILED TO CURB INFLATION OVER THE PAST TWO YEARS. HE ATTRIBUTES HIGHER INFLATION TO LOW PRODUCTIVITY, HIGH PUBLIC SPENDING AND FUEL PRICE HIKES, RATHER THAN LENDING TO THE ECONOMY.

12. MOST OF THE COMMERCIAL BANKS, AT LEAST MARKET LEADERS SUCH AS RAIFFEISEN BANK AND HYPO ALPE ADRIA BANK, GRUDGINGLY ACKNOWLEDGE THAT THE NBS HAS REASON TO FOCUS ON RETAIL LENDING, BUT THEY ARGUE THE MEASURES SHOULD NOT TARGET THE CORPORATE SECTOR. THEY WORRY THAT MORE COMPANIES WILL SIMPLY BORROW OVERSEAS; SOME BANKERS WARNED THAT LOCAL BANKS WILL SIMPLY SELL THEIR LOANS TO THEIR OVERSEAS PARENTS. AT THE SAME TIME, BANKERS AGREE THAT CONSUMERS WILL CONTINUE TO BORROW, DESPITE HIGHER RATES, BECAUSE OF PENT-UP CREDIT DEMAND.

INFLATION DEBATE CONTINUES

13. THE CENTRAL BANK AND ECONOMISTS AGREE THAT HIGH AGGREGATE DEMAND IS CAUSING BOTH INFLATION AND CURRENT ACCOUNT PRESSURES. THE DEBATE FOCUSES ON THE EXTENT TO WHICH DEMAND PRESSURE IS THE RESULT OF RISING PRIVATE CONSUMPTION DRIVEN BY SURGING COMMERCIAL BANK LENDING, AS OPPOSED TO THE HIGH LEVEL OF PUBLIC SPENDING AND AN UNRESTRUCTURED PUBLIC SECTOR.

14. ALTHOUGH SERBIA RECORD A BUDGET SURPLUS OF 2.2 PERCENT OF GDP IN 2005 AND PROJECTS A 1.3 PERCENT SURPLUS THIS YEAR, MANY BELIEVE THAT THE HIGH LEVEL OF SPENDING (CONSOLIDATED BUDGET REVENUES IN 2005 WERE 43.5 PERCENT OF GDP) IS FUELING INFLATION. THE GOS EXPECTS A PRIVATIZATION WINDFALL THIS YEAR, WITH ADDITIONAL REVENUES OF MORE THAN 1 BILLION EUROS EXPECTED FROM SELLING THE SECOND CELLULAR PROVIDER AND TWO BANKS. ALTHOUGH THE GOS PROMISED THE INTERNATIONAL MONETARY FUND (IMF) THAT IT WOULD SAVE ALL ADDITIONAL REVENUES, FINANCE MINISTER DINKIC HAS ARGUED PUBLICLY THAT INFLATION IS NOT A SERIOUS THREAT, WHILE THE NEED TO GENERATE GROWTH AND EMPLOYMENT THROUGH PUBLIC WORKS IS MORE PRESSING. JELASIC

WARNED THAT 1 BILLION EUROS IS 17 PERCENT OF SERBIAN BUDGET; SUCH EXPENDITURES, EVEN OVER SEVERAL YEARS, SURELY WOULD EXACERBATE INFLATION.

15. AT A RECENT ROUNDTABLE IN THE NATIONAL BANK, STOJAN STAMENKOVIC, A PROMINENT LOCAL MACROECONOMIST, MAINTAINED THAT HIGH INFLOWS OF FOREIGN CAPITAL ARE THE MAIN CAUSE OF INFLATION, TOGETHER WITH THE LOW DEGREE OF COMPETITION IN THE RETAIL SECTOR. ON THE OTHER HAND, VLADIMIR GLIGOROV, AN ANALYST WITH THE VIENNA INSTITUTE FOR INTERNATIONAL ECONOMIC STUDIES, ARGUES THAT ALL OTHER COUNTRIES IN THE REGION HAVE FACED SIMILAR INFLOWS, ALONG WITH SIMILAR PROBLEMS SUCH AS THE GROWTH OF SALARIES ABOVE PRODUCTIVITY AND EUROIZATION, BUT ALMOST NONE OF THEM HAVE SUFFERED SUCH INFLATION. HE LAYS THE BLAME ON HIGH PUBLIC EXPENDITURES.

16. ON THE OTHER HAND, SOME ECONOMISTS CLAIM THAT NATIONAL BANK SHOULD FURTHER TIGHTEN THE MONETARY POLICY, TO CURB DEMAND AND INFLATION. STAMENKOVIC EVEN SUGGESTED THAT ADMINISTRATIVE MEASURES FOR LIMITING THE FOREIGN CREDITS SHOULD BE CONSIDERED. HE PROPOSED LIMITS ON FOREIGN DEBT CONNECTED TO A BANK'S EQUITY CAPITAL, ALONG WITH A DECREASE OF THE REQUIRED RESERVE ON DOMESTIC DEPOSITS FROM THE PRESENT 40 PERCENT.

RIISING CURRENT ACCOUNT DEFICIT AND EXCHANGE RATE

17. THE CENTRAL BANK ALSO IS CLOSELY WATCHING THE CURRENT ACCOUNT. THE FOREIGN TRADE DEFICIT IN THE FIRST QUARTER OF 2006 WAS 34.4 PERCENT HIGHER THAN IN THE SAME PERIOD OF 2005, BUT ABOUT 10 PERCENTAGE POINTS LOWER THAN THE SAME PERIOD OF 2004. HOWEVER, JELASIC, POINTING TO THE DISTORTION OF EARLY 2005 RESULTS BY IMPOSITION OF A VAT, SAID HE WAS NOT ESPECIALLY WORRIED BY THE FOREIGN TRADE NUMBERS.

18. THE POSITIVE DEVELOPMENT OF EXPORTS, UP BY 27.6 PERCENT IN THE FIRST QUARTER, CONTINUED DESPITE DINAR APPRECIATION. (THE DINAR APPRECIATED IN REAL TERMS 3.5 PERCENTAGE POINTS RELATIVE TO THE EURO.) THIS INDICATES THAT THE LOW RATIO OF EXPORTS TO GDP (ABOUT 20 PERCENT IN 2005) IS MORE THE RESULT OF STRUCTURAL WEAKNESSES IN THE ECONOMY. JELENA PETKOVIC, THE GENERAL MANAGER OF TIGAR CORPORATION, SERBIA'S THIRD LARGEST EXPORTER, SAID THAT TIGAR WOULD NOT EXPORT MORE IF THE EXCHANGE RATE HAD BEEN DIFFERENT, ALTHOUGH SHE DID EXPRESS CONCERN OVER INFLATION.

19. THE CURRENT ACCOUNT DEFICIT FOR THE FIRST QUARTER REACHED EURO 478 MILLION, WELL BELOW THE FOREIGN CAPITAL INFLOW (EURO 804 MILLION). HOWEVER, THE FINANCING WAS THROUGH RISING INDEBTEDNESS.

20. ECONOMISTS AND BANKERS AGREE THAT THE EXCHANGE RATE SHOULD BE SET BY THE MARKET, THAT DINAR SHOULD BE LET TO APPRECIATE. HOWEVER, JELASIC SAID THAT THE BANK IS STEADILY DECREASING ITS INTERVENTION IN THE FOREIGN EXCHANGE MARKET BY LOWERING ITS PURCHASES FROM EXCHANGE BUREAUS. DATA BEARS OUT HIS ASSERTION; THE NBS SHARE OF FOREIGN EXCHANGE PURCHASES FROM RETAIL EXCHANGE DEALERS DECREASED FROM 55 PERCENT IN 2005 TO 44 PERCENT IN THE FIRST QUARTER. JELASIC SAID THAT THE BANK MORE AND MORE WAS FINDING DEMAND FOR EURO WEAK IN ITS FIXING SESSIONS, WITH COMMERCIAL BANKS UNDERCUTTING THE CENTRAL BANK'S RATE.

21. ECONOMIC ANALYSTS AGREE THAT CAPITAL OUTFLOWS SHOULD BE LIBERALIZED TO PERMIT THE MARKET TO DETERMINE THE EXCHANGE RATE AND TO RELIEVE THE PRESSURE FROM HARD CURRENCY INFLOWS. ACCORDING TO JELASIC, THE NATIONAL BANK WILL NOT INTERVENE TO STOP DINAR APPRECIATION, BUT STILL WILL NOT FULLY LIBERALIZE CAPITAL OUTFLOWS BY ENDING RESTRICTIONS FOR INDIVIDUALS.

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